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JUDY CHU, Ph.D.
CHAIR
CALIFORNIA STATE BOARD OF EQUALIZATION

April 21, 2008

Honorable Don Perata
President Pro Tempore
California State Senate
State Capitol, Room 205
Sacramento, CA 95814

Honorable Fabian Nunez
Speaker
California State Assembly
State Capitol, Room 219
Sacramento, CA 95814

Honorable Darrell Steinberg
President Pro Tempore - Elect
California State Senate
State Capitol Room, 4035
Sacramento, CA 95814

Honorable Karen Bass
Speaker - Elect
California State Assembly
State Capitol, Room 319
Sacramento, CA 95814

Honorable Denise Ducheny
Budget Committee Chair
California State Senate
State Capitol, Room 5035
Sacramento, CA 95814

Honorable John Laird
Assembly Budget Chair
California State Assembly
State Capitol, Room 6026
Sacramento, CA 95814

Dear Speaker Nunez:

You are well-aware that California faces a General Fund deficit over the next two years in excess of \$16 billion. Based on my previous experience as a legislator, I do not believe that it is possible to resolve this shortfall through spending cuts alone. Ongoing state programs in support of our schools, public health and safety realistically cannot be scaled back within a single fiscal year to generate the savings necessary to bring the budget into balance. Absent new revenues, our state government faces the prospect of insolvency in the 2008-09 fiscal year.

As you and your colleagues in the Legislature evaluate revenue raising options in the coming months, I urge you to consider extending California's sales and use tax base to certain services. Doing so would modernize our sales tax base to better reflect commerce in the 21st century as well as stabilize state General Fund revenues, which are prone to cyclical fluctuations. Upon receiving statutory authorization, the Board of Equalization is capable of administering an extension of the sales tax to a variety of services immediately, as I discuss below.



Sales and Use Tax Base in California

California's sales tax was enacted in 1933 and imposed at a rate of 2½ percent on the retail sale of merchandise in the state. The tax was enacted largely to offset the declining property tax revenues that occurred during the Great Depression. The use tax was enacted two years later and imposed on consumers of merchandise used in California having been purchased out-of-state. Given that the manufacture and sale of physical goods was the predominant form of economic activity at that time, the sales tax base was defined to include the retail sale of "tangible personal property." The sales tax was intended to be a broad-based tax on economic activity as represented by consumer spending.

Since the 1930s, the state's economy has shifted away from the manufacture of tangible goods and toward exchanges of intangible goods and services. As a consequence, the share of personal income spent on tangible personal property has declined, and a growing proportion of consumer spending is not captured as part of the state's sales tax base. In the early decades of the tax, the proportion of disposable personal income expended on taxable sales was about two-thirds. By 1980, taxable sales had declined to 57 percent of disposable personal income. Today, taxable sales constitute just 43 percent of disposable personal income.

As consumption patterns diverged from the sales tax base, the proportion of state General Fund revenues derived from the sales tax has declined. The sales tax portion of the General Fund dropped from 37 percent in 1980-81 to just 28 percent in 2007-08, even though the state sales tax rate (the amount deposited in the General Fund) increased from 4.75 percent to 5.0 percent during that period. The state has on several occasions through the years raised the sales tax rate to meet its spending obligations, but has failed to broaden the sales tax base to reflect commerce in the 21st century.

Sales and Use Taxes on Services in Other States

California is certainly not alone in experiencing a decline in the size of its sales tax base, relative to overall economic activity. Other states have experienced similar declines; however, many states also tax a spectrum of intangible goods and services. In some states, this broader base is simply part of the original tax system, as in the case of Hawaii and New Mexico. Other states have acted to expand their base to include certain intangible goods and services in response to economic changes or to eliminate inconsistent tax treatment.

The potential tax base represented by services is huge. At the state General Fund rate of 5 percent, a tax levy on a broad base of services in California could generate in the neighborhood of \$45 billion annually. This broad base includes such services as construction, legal, accounting, engineering, health care, and transportation. Some of these services may be difficult to tax due to administrative or political factors—such as business services or health care. Nevertheless, many of these services are taxed by other states.

According to the Federation of Tax Administrators' (FTA) most recent survey, only Hawaii and New Mexico have a broad-based tax on services; yet many states tax a substantial number of services. Six states tax over 100 of the 160 individual services tracked in the FTA survey. In contrast, California taxes only 23 services. Most other large industrial states tax substantially

more services. For example, Texas taxes 81 services, Connecticut 80, Wisconsin 74, Ohio 68, Florida 64, New York 56, New Jersey 55, and Pennsylvania 55.

What Services Do Other Major Industrial States Tax?

According to the FTA, the types of services typically taxed by other industrial states include: construction, transportation, non-professional business support, entertainment and recreation, automobile repair and maintenance, miscellaneous repair and maintenance, personal services, and entertainment and recreation services. There are also several other miscellaneous categories which are subject to sales taxation in these states.

The revenue impact of taxing certain of these services would be substantial. For example, a tax on entertainment would generate General Fund revenue of about \$1.7 billion annually, and the taxation of certain construction services would result in revenue of about \$1.2 billion annually. Table 1 below estimates the annual General Fund revenue impact in California for a selected “portfolio” of services that are taxed by at least one of the other industrial states identified above. In most cases, the particular service is taxed by at least two of the industrial states we examined.

Table 1:
Estimated General Fund Revenue of Taxing Services Taxed By Other Industrial States
(Revenue in \$ Millions)

Area of Service	Specific Service or Activity	Annual Revenue
Agriculture	Breeding, boarding, etc.	\$10
Drilling and Mining	Oil exploration, grading, etc.	\$34
Construction	Non-residential	516
	Other heavy construction	26
	Building foundation and exterior	159
	Building equipment	219
	Building finishing	142
	Other specialty trade	103
	Sub-total	\$1,165
Automobile Repair and Service	Dealers	627
	Repair shops	410
	Towing	33
	Car washes	39
	Parking	86
	Sub-total	\$1,195
Transportation	Urban transit	29
	Interurban transit	5
	Taxi and limousine	49
	Charter bus	16
	Other transit	37
	Sub-total	\$136
Storage and Warehousing	Refrigeration, self-storage, warehouse, etc.	160
	Mini-storage and self-storage	54
	Sub-total	\$214

Business Services	Advertising and related	478
	Office administration	282
	Facilities support	78
	Employment services	937
	Business support	398
	Investigation and security	304
	Building and dwelling	792
	Sub-total	\$3,269
Entertainment and Recreation	Film and movies	86
	Performing arts	108
	Spectator sports	172
	Promoters	72
	Agents and managers	115
	Independent artists	497
	Museums and similar	2
	Amusement, gambling and recreation	650
	Sub-total	\$1,702
Repair and Maintenance	Precision equipment repair	104
	Mechanical equipment repair	69
	Personal and household repair	108
	Sub-total	\$281
Personal Services	Hair, skin and nails	243
	Dry cleaning and laundry	187
	Other	270
	Sub-Total	\$700
	TOTAL	\$8,706

Clearly, a substantial amount of revenue could be generated by levying the sales tax on services that are currently being taxed by other industrial states. Even if California took a much more limited approach, however, it could still generate considerable revenue. For example, if California simply limited its expansion of the sales tax to services being taxed by New York and New Jersey alone (instead of simply *any* of the industrial states named above), the additional annual revenues would likely be in excess of \$1.5 billion annually.

What Services are Most Frequently Taxed By Other States?

A slightly different way of looking at the issue is to examine what services are most frequently taxed by all other states. Among the top five general categories of services taxed, California already taxes utility and telephone services through statewide assessments or local utility user taxes and franchise fees. The state also subjects most leases and rentals to the sales tax. Thus, in terms of broad categories, the remaining types of services taxed most frequently by states (but not taxed by California) are: automotive repair and service, entertainment and recreation, repair and maintenance, and personal services.

Each of the specific services within these broad categories is taxed by about half of the states that currently levy a comprehensive consumption tax, such as the sales and use tax. Except for a very few specific types, California does not currently tax services within these general categories. The

General Fund revenue impact of taxing these services frequently taxed by other states is shown in Table 2, below. As shown in the table, even if California were to restrict the expansion of the sales tax base to only those services taxed by a large number of states already, the annual revenue impacts could be considerable—approaching \$2.7 billion.

Table 2:
Estimated General Fund Revenue of Taxing Services Frequently Taxed By Other States
(Revenue in \$ Millions)

Area of Service	Specific Service or Activity	Annual Revenue
Automobile Repair and Service	Dealers	627
	Repair shops	410
	Towing	33
	Car washes	39
	Parking	86
	Sub-Total	\$1,195
Entertainment and Recreation	Film and movies	86
	Performing arts	108
	Spectator sports	172
	Museums and similar	2
	Amusement, gambling and recreation	650
	Sub-total	\$1,018
Repair and Maintenance	Precision equipment repair	104
	Mechanical equipment repair	69
	Personal and household goods	108
	Sub-total	\$281
Personal Services	Dry cleaning and laundry	\$187
	TOTAL	\$2,681

Administrative and Implementation Issues

The sales tax could be most easily extended to services delivered by businesses already registered with the Board of Equalization as sellers of tangible personal property. Most of the services listed in Table 2 are provided by businesses likely to already be registered sellers with the Board and familiar with the collection and remittance process. These businesses generally are familiar with collecting sales tax reimbursement, filing returns with the Board, and remitting the tax on a timely basis. For some types of businesses—such as movie theaters—extending the definition of gross receipts subject to the sales and use tax would simply require including admissions fees with the concession sales for which sales tax is already remitted to the Board.

If the sales tax were extended to services provided by businesses not registered with the Board, the Board would need to engage in outreach activity to inform affected service businesses of their new tax-related obligations. This problem is not insurmountable, but could delay revenue collections.

The projected budget deficit for 2008-09 provides the Legislature the opportunity to pursue sales tax reforms that not only would result in short-term revenue improvements for California, but also a more stable and equitable tax structure.

I hope this information is useful to you in your deliberations. Should you have any questions regarding the revenue options discussed above, please contact me.

Sincerely,

A handwritten signature in black ink that reads "Judy Chu". The signature is written in a cursive, flowing style.

Judy M. Chu, Ph.D.
Chair, California Board of Equalization

cc: Vice-Chair and Members of Senate Committee on Budget and Fiscal Review
Vice-Chair and Members of Assembly Committee on Budget